TO: TERRY BISS

FR: WILLIAM R. JUBECK

RE: COUNTY CONTROLLER AUDIT

DA: OCTOBER 11, 1999

The Beaver County Controller delivered a draft report of the recently completed eight month audit of the Center's purchasing activities to the Center on Thursday, October 8. The field work was performed by lead auditor, Bob Marzano and Associates Kristy Jenkins and Cheryl Spagnola. A meeting to review the draft report is scheduled for 10:00 AM, Wednesday, October 13.

The audit report begins by stating that "The management of the Beaver Valley Geriatric Center is responsible for establishing and maintaining an internal control structure". It continues by affirming that "estimates and judgements by management are required to assess the expected benefits and related costs of internal control structure policies and procedures". JUDGEMENTS, BENEFITS AND COSTS ARE THE KEY ELEMENTS IN THAT AFFIRMATION. Put another way, in management's judgement would the potential benefits of an additional control exceed its real and certain cost, i.e.

justify the addition of an employee at an annual cost of $30,000 or more.

The introduction to the report continues by citing the objectives of internal control which are to provide "reasonable but not absolute assurance" that

- "assets are safeguarded against loss from unauthorized use or disposition"
- "transactions are executed in accordance with management's authorizations"

and

- "recorded properly to permit the preparation of the financial statements in accordance with prescribed policies".

THE AUDIT REPORT DOES NOT DISCLOSE ANY INSTANCE OF MATERIAL ASSET LOSS, MATERIAL TRANSACTION UNAUTHORIZED BY MANAGEMENT OR MATERIAL ERROR IN RECORDING JEOPARDIZING THE INTEGRITY OF FINANCIAL STATEMENTS.

The introduction continues by stating that "Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected". Further, "reliance . . . is subject to the risk that procedures may become inadequate because of changes in condition or that the effectiveness of the design and operation of policies and procedures may deteriorate". IN SHORT, THE EXISTENCE OF AN ELABORATE SYSTEM OF INTERNAL CONTROLS CANNOT BE A GUARANTEE OF ITS OBJECTIVES NOR CAN THE ABSENCE OF SUCH A SYSTEM BE CONSTRUED AS A GUARANTEE OF FAILURE TO MEET THOSE OBJECTIVES.

The introduction concludes by stating that the auditors findings constitute "reportable conditions" under AI CPA standards. "Reportable conditions "are defined as deficiencies in internal control that "could adversely affect the Beaver Valley Geriatric Center's ability to record, process, summarize and report financial data . . . ." Interestingly, neither the Center's 1998 external financial audit by the certified public accounting firm of Case, Sabatini & Company, nor any earlier audit expresses any similar concern.

The final statement in the introduction alludes to the report becoming a matter of public record. Unfortunately, the current form of this report could lend itself to misinterpretation resulting in the loss of confidence in the Center's operations and the possibility of some parties raising the issue of privatization.

The first finding/conclusion stated that:

> "There was a lack of compliance to County Code bidding and quotation requirements"

The audit sample of transactions was as follows per the report:

Vendors	Orders	Volume
92	1018	$3,613,526

Non-compliant transactions were identified as follows:

	Orders	Volume
No formal bid	18	$382,025
Challenged exemption claims	14	597,034
Incomplete or non-documented quotes	10	60,510
	42	$1,039,569
% Total sample	4.1	28.8
% Compliance	95.9	71.2

Some of the vendors identified in the "No formal bid" subtotal were believed to qualify for exemption. Omitting the transactions identified as "challenged exemption claims" produces a compliance rate of 97.3% and 87.7% on orders and volume, respectively. <u>These compliance rates support an unmistakable intent to comply with the County Code</u>. The Center has acted to clarify ambiguities relative to County Code purchasing that will increase its compliance. Two of the items identified as requiring formal bid, representing 38% of the total volume, have been bid and each received only a single response - the former vendor.

The second finding/conclusion stated that:

"There was a lack of internal controls over purchasing"

This finding/conclusion was largely prompted by the absence or incompleteness of purchase orders.

Without addressing the details relative to pricing, discounts, freight etc., suffice it to say that, although the Center's practices can and will be strengthened as a result of the audit, PURCHASING AT THE CENTER IS CONTROLLED. This is accomplished through -

1. Annual cost center budget authorizations based

on census projections.

2. Designated personnel authorized to purchase and approve payments.
3. Double entry General Ledger recording of invoices.
4. Monthly budget variance reporting.
5. Internal Control Coordinator reviews.

Further, recent PACAH cost surveys show the Center at or below average in most purchase cost categories per statistical unit. This could not be accomplished in the absence of control.

The third finding/conclusion stated that:

> "There was a lack of internal controls over contracts"

This finding/conclusion was largely prompted by the absence of Board of Commissioner approval for change orders totaling $223,007 on $3,002,900 of construction cost during 1997-98. The change orders represented 7.4% of the total and were applicable to nine separate publicly-bid contracts. The Board of Commissioners have since directed the County Engineer to actively involve himself in the

Center's construction/renovation program to avoid a repetition of these events.

The remaining findings/conclusions relate to:

- a lack of follow-up on credits (an infrequent and usually low dollar event).
- a lack of segregation of duties in respect to initiation of P.O., receipt of goods and approval for payment (many transactions are for services for which this model would not apply).
- a lack of verification of Nutrition Management approved expenditures. (as an independent contractor with a defined length of tenure, its cost performance is a condition of continued service).

The Controller's audit will serve as a valuable reference tool to strengthen and reinforce an area of the Center's operations that due to a number of competing and compelling demands has not received a great deal of recent attention. These competing and compelling demands have included new Medicaid and Medicare payment systems, more rigorous enforcement of licensure requirements and the need to develop more inventive ways of maintaining census. The ACTUAL, certain losses that each of these areas would have produced with inattention far exceed the POTENTIAL losses associated with the matters referenced in the report. This demonstrates management's judicious balancing of benefits and costs in internal control referenced in the introduction to the report.

At this very time, in fact, absent concerted management attention, the Center is at risk of losing over $1 million in MA funding in the year 2000 due to its declining occupancy. MA payment regulations provide for a bonus payment annually to those facilities having an overall occupancy of 90% in the prior year. The Center's occupancy through September is 90.6%. This concern is supported by a headline article in the October 11, 1999 Pittsburgh Post Gazette describing the financial impact of declining occupancy on the neighboring Allegheny County John J. Kane county nursing homes.

Despite the identified areas in need of strengthening, the Center has purchased wisely. It's practices have helped it to be one of the lower cost county nursing homes in its peer group. This has been of direct benefit to the County and its taxpayers as the Center has not required any cash operating subsidy in the last four years. As you are also aware the Center has self-funded over $5 million dollars in capital improvements during that same time frame and reserved sufficient funds to fully retire its debt. NONE OF THIS COULD HAVE BEEN POSSIBLE IN THE ABSENCE OF SOUND FISCAL MANAGEMENT AND CONTROL.